This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 02 TAIPEI 003118

SIPDIS

STATE PLEASE PASS AIT/W AND USTR

STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA

USTR FOR AUDREY WINTER AND TIM WINELAND

USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASURY FOR OASIA/ZELIKOW AND WISNER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A
TAGS: EINV EFIN ECON PINR TW
SUBJECT: Effects of RMB Appreciation on Taiwan

¶1. SUMMARY. The renminbi's (RMB) appreciation of 2%
against the US dollar (USD) on July 21 has caused the NTD
and other Asian currencies to strengthen against the US
dollar. However, market intervention by Taiwan's Central
Bank of China (CBC) has reduced the NTD appreciation to less
than other regional currencies. Small daily fluctuation
limits set by the PRC will lead to predictability of the
RMB's gradual appreciation, which in turn will attract
speculative money to flow into this region, including
Taiwan, over the next five to six months. END SUMMARY.

RMB Appreciation

¶2. On the night of July 21, 2005, the PRC revalued the RMB
by two percent from 8.3 RMB per USD to 8.1 RMB per USD. At
the same time, the PRC adopted a controlled, flexible
exchange rate system. It will allow the RMB exchange rate
to fluctuate, but the daily fluctuation will be subject to
limits of 0.3% above and below the closing rate of the
previous day.

Reaction of Taiwan's Foreign Exchange Market

¶3. In response to the RMB's 2% appreciation on July 21,
Taiwan's foreign exchange (FX) market opened July 22 at
NT$31.55 per USD, 1.26% stronger than the closing rate of
July 21. The NTD exchange rate did not continue to gain
strength, and its appreciation against the USD did not reach
a magnitude of 2%, as the Japanese yen and Korean won did.
The volume in the first two hours of the trading session on
July 22 expanded to US$746 million from normal levels below
US$500 million.

¶4. Local FX observers believe that Taiwan's Central Bank of
China (CBC) started its intervention right after the FX
market opened on the morning of July 22. Consequently, the
NTD exchange rate declined slightly to NT$31.651 per USD in
the final hour before the market closed. Meanwhile, the CBC
issued a press release to stress that Taiwan's trade surplus
in the first half of this year dropped 90% from the same
period in 2004. The CBC attempted to use the 90% drop in
trade surplus to justify the NTD's smaller appreciation
against the USD compared with other currencies in the
region.

Stock Market

¶5. Market observers expect the RMB appreciation to drive up
Taiwan's stock prices. However, on July 22, Taiwan's stock
price index did not rise; instead, the index declined 13.3
points to close at 6,380.73 points. Observers believe that
the 13.3-point decline mainly resulted from profit-taking
after a 10-percent increase over the past five trading days.
The longer-term trend will override this kind of market
correction.

COMMENT

¶6. The RMB's 2% appreciation was far less than rise of more
than 10% expected by the Taiwan public. Local observers
believe that the RMB will continue to gain strength over the
next five to six months. With the daily fluctuation limits
of 0.3% above and below the closing rate of the previous
day, the RMB will follow a predictable trend of gradual
appreciation over five to six months. The predictability of
RMB appreciation is likely to continue to attract
speculative capital to China and neighboring economies,
including Taiwan. The speculative capital will not only
firm up the NTD, but also drive up Taiwan's stock prices.

¶7. The RMB appreciation will blunt the competitive edge of China-based production lines. However, in the short run, the RMB appreciation will drive up the value of China-based assets (in terms of NTD). Therefore, the share prices of Taiwan companies operating China-based production lines may increase over the near term.
PAAL